POWDER RIVER COAL COMPANY

IBLA 96-566 Decided December 6, 2001

Appeal from a decision of the Associate Director for Policy and Management Improvement, Minerals Management Service, denying in part an appeal from an order assessing additional royalty for coal production from Federal coal lease M75-321779-0. MMS-92-0478-MIN.

Affirmed as modified.

1. Coal Leases and Permits: Royalties

The obligations of a lessee under a Federal coal lease are not those of a fiduciary but rather require the exercise of reasonable business judgment in all actions relating to the mining and marketing of the coal.

2. Coal Leases and Permits: Royalties

Where the record establishes that a coal lessee failed to exercise reasonable business judgment resulting in the receipt by the lessee of less than fair market value for a shipment of coal, the Government, as lessor, has the right to insist that its royalty payment be based on the fair market value of the coal that would have been obtained had the lessee exercised reasonable business judgment.

APPEARANCES: Ryan M. Tew, Esq., Gillette, Wyoming, and Thomas J. Mikula, Esq., James R. Bird, Esq., Washington, D.C., for Powder River Coal Company; Howard W. Chalker, Esq., Division of Energy and Resources, Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE BURSKI

Powder River Coal Company (Powder River) has appealed from a July 12, 1996, decision of the Associate Director for Policy and Management Improvement, Minerals Management Service (MMS), granting in part and denying in part an appeal from a September 16, 1992, order of the Area Manager, Dallas Area Compliance Office (DACO), MMS, directing Powder River to pay additional royalties for coal production from Federal coal lease

M75-321779-0. For the reasons set forth below, while we affirm the decision directing Powder River to pay additional royalties, we modify the fair market valuation used in the Associate Director's decision.

On January 1, 1985, Rochelle Coal Company (Rochelle), 1/ which then held lease M75-321779-0, entered into a Coal Supply Agreement (Agreement) with Kansas City Power and Light (KCP&L). Under the terms of the Agreement, Rochelle agreed to sell to KCP&L, and KCP&L agreed to buy from Rochelle, certain quantities of coal for use at KCP&L's Hawthorn Unit #5 and Montrose Units #1, #2, and #3. Rochelle was, at that time, a wholly-owned subsidiary of Powder River, which in turn was a wholly-owned subsidiary of Peabody Holding Company.

The Agreement required that Rochelle supply KCP&L with coal having a sodium oxide content of no more than 2.25 percent (measured as a percentage of the weight of the ash produced when KCP&L burned the coal). See Article III.B. At the time of the December 16, 1986, shipment, the contract price, as computed under the terms of the Agreement, was $7.205 per ton F.O.B. seller's railroad loading track at the mine. See Article IV.B, Article VIII.A. The Agreement provided that KCP&L could accept any shipment which failed to conform to the contract specifications and pay a reduced price of no less than 90 percent of the adjusted price then in effect. The price to be paid depended on "the reasonable value of such trainload to * * * [KCP&L] for operation of its Units, considering loss of efficiency and excess operating and maintenance costs" resulting from the nonconformity. (Article III.C.2.)

Alternatively, KCP&L was entitled to reject a nonconforming shipment altogether and to request a replacement shipment of conforming coal. See Article III.C.1. In such a case, Rochelle was required to bear the costs of having the shipment returned to the mine or having it diverted to another purchaser. Id. It is also important to note that, under the terms of the Agreement, KCP&L or the railroad was obligated to "provide all open top rail cars necessary for transporting coal purchased by [KCP&L]," which rail cars were required "to meet the specifications of both the Association of American Railroads and the rail carriers providing carriage of the coal" and also be compatible with Rochelle's trackage, coal storage, and loading facilities. (Article VII.B.)

On December 16, 1986, Rochelle sold a trainload of 11,182.875 tons of coal to KCP&L that, as Rochelle subsequently discovered, did not conform to the sodium specifications of the Agreement. The sodium oxide content of the coal was 2.32 percent, which exceeded the 2.25 percent limit allowed in the Agreement. (Dec. 17, 1986, Shipment Quality Report.) As evidenced

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1/ On January 24, 1984, Peabody Holding Company, then holder of the lease, had assigned the portion of the lease in question to Powder River, which in turn subleased to Rochelle on June 14, 1984. Subsequently, in January 1996, Rochelle was merged into Powder River. Since, however, Rochelle was the operating entity throughout the relevant time period, we will generally refer to Rochelle throughout this decision.

by the Sales Call Report dated December 18, 1986, KCP&L rejected the shipment. Rochelle then attempted to sell this shipment to other customers, but, while other customers were willing to accept the coal even given its sodium oxide content, none had facilities which would allow them to off-load the coal because of the nonstandard rail equipment (owned by KCP&L) on which the coal had been shipped. (Jan. 13, 1987, Sales Call Report.)

Thereafter, in a letter of agreement dated January 16, 1987, and signed by KCP&L and Rochelle, KCP&L agreed to accept the shipment of coal at $.01 per ton. Rochelle agreed to reimburse KCP&L for any additional freight-related charges, over and above the normal transportation charges, which resulted from the unacceptable coal quality and KCP&L's subsequent rejection of the shipment. Both parties also agreed that Rochelle would not be held liable for damage to KCP&L's Hawthorn plant resulting from KCP&L's acceptance and use of this coal shipment. (Letter Agreement, Jan. 16, 1987.) 2/

The September 16, 1992, order, which resulted from an MMS audit of royalties paid by Powder River on Federal leases for the period July 1, 1986, through June 30, 1991, advised Powder River that it had failed to properly value the 11,182.875 tons of coal sold from lease M75-321779-0 to KCP&L during December 1986, which resulted in a royalty underpayment of $10,057.60. These additional royalties were computed based on the difference between the purchase price for fully conforming coal as specified in the Agreement and the price of $.01 per ton negotiated by the parties for the nonconforming shipment. In support of this determination, MMS cited various regulations in the then current provisions of Title 30 of the Code of Federal Regulations.

On appeal to the Director, MMS, Rochelle asserted that the September 16, 1992, order should be reversed because MMS based the order on a version of the coal royalty regulations that became effective after the December 16, 1986, shipment, noting that the regulations in question expressly applied only "to production on or after the effective date of the final rule for all leases," which was March 1, 1989. See 54 FR 1492 (Jan. 13, 1989).

Rochelle argued that it had paid all royalties due the Government based on the arm's length purchase price of $.01 per ton for the December 16, 1986, shipment of coal. Rochelle pointed out that, under the circumstances, the sale of coal to KCP&L at the purchase price, pursuant to the January 16, 1987, agreement, represented Rochelle's only viable alternative at that time, since it had been unable to find other purchasers for

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2/ Prior to reaching this agreement, KCP&L had agreed to accept the shipment if Rochelle would agree to indemnify KCP&L should the use of the nonconforming coal adversely affect operations at its Hawthorn plant. Being aware that the Hawthorn plant had been shut down earlier in 1986 because of problems associated with a high sodium coal shipment from another mine, Rochelle apparently thought it was prudent to negotiate an agreement which did not expose it to liability should these problems recur.

the shipment because the unusual configuration of KCP&L's rail cars into which the coal had been loaded made those cars incompatible with the facilities of other potential purchasers.

Rochelle claimed that none of the regulatory provisions cited in the September 16, 1992, decision supported MMS's determination that Rochelle owed royalties on the difference between the actual purchase price of $.01 per ton and the $7.205 per ton contract price for coal that conformed to the quality requirements of the January 1, 1985, Agreement. Rochelle asserted that, underlying the decision's reliance on these provisions, was the erroneous assumption that a lessee owes an absolute duty to guarantee coal quality.

In a supplemental statement of reasons filed on December 18, 1992, Rochelle referred to a Freedom of Information Act request it had filed with MMS seeking information as to whether MMS had ever assessed or considered assessing royalties on nonconforming coal on a different basis than that used for coal that conformed to contractual specifications. Rochelle argued that MMS's inability to locate any records responsive to Rochelle's request demonstrated the novelty of MMS's position in this case rejecting the actual purchase price of nonconforming coal as the basis for computing royalties owed.

Rochelle also submitted a February 16, 1993, affidavit of Douglas A. Wagner, who had been the manager of the Rochelle Mine in December 1986 when the nonconforming shipment took place. Wagner stated that, prior to the December 16, 1986, shipment, Rochelle had shipped 42 trainloads of coal to KCP&L in 1986 without incident. Wagner described the process for testing the quality of the coal as follows:

> 6. Prior to any excavation at Rochelle, subcontractors hired by Rochelle had conducted core sample tests of the coal seam to test the coal's quality, including its sodium content. * * * The initial core sample analyses revealed that some areas of the mine contained coal with higher concentrations of sodium than others and that sodium concentrations varied by depth, thereby producing differences in sodium concentration among the three (3) levels or benches that we were mining.
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> 7. For customers, like KCP&L, that required lower sodium coal, Rochelle's engineers established guidelines to ensure a proper blend of coal. The process of excavating coal from both high and low sodium areas or benches, running the mix through the transfer building and into a storage silo from which the coal was loaded into unit trains produced an acceptable blend of coal. A continuous sampler in the transfer building collected coal samples shortly before the coal was loaded into rail cars. These samples were analyzed to determine the "as shipped" coal quality characteristics, including sodium.

> 8. * * * Because of limited facilities for coal storage, * * * coal for a particular customer was generally mined only after notice that a train for the coal was due to arrive. Rochelle typically did not receive more than twelve (12) hours' notice of a train's arrival. The railroad had no contractual obligation to give more than four (4) hours' notice. Upon receiving notice, Rochelle would begin excavating, preparing and loading coal into the storage silo * * *, a process which took approximately six or seven hours to complete. * * * [S]amples for testing were collected during this process. After the samples were collected it took an additional fourteen (14) hours for the results to become available. Thus, Rochelle, in nearly every case, including the incident in question, never had the test results in hand until a train had been fully loaded and was already en route.
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> 9. At the time of the December 16, 1986, nonconforming shipment, Rochelle's procedures for excavating, blending, testing and loading coal conformed with customary industry practice. In particular, companies routinely loaded and shipped coal to customers before test results of coal quality became available.
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> 10. * * * Our investigation did not reveal that we had departed from Rochelle's customary procedures or from industry practice.
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> 11. Rochelle Mine has only had facilities for loading coal and has never had facilities for unloading coal. To the best of my knowledge, it is not customary in the industry to have coal unloading facilities at a mine.

(Affidavit of Douglas A. Wagner, dated Feb. 16, 1993, at 2-4.)

In her decision, dated July 12, 1996, the Associate Director acknowledged that the September 1992 order erroneously referred to valuation regulations with a post-December 1986 effective date and agreed with Rochelle's assertion that the regulations codified at 30 CFR 203.200 (1986) were the appropriate regulations for determining the valuation for royalty purposes of coal produced and sold from Federal leases during the time period in question. (See Decision at 4 n.1.) She noted that these regulations provided that, where Federal royalty is calculated on a percentage basis, the value of coal was the gross value at the point of sale, normally at the mine, computed on the basis of the unit sale or contract price times the number of units sold, unless MMS determined that a contract was not a bona fide transaction between independent parties. See generally 30 CFR 203.200(f) and (g)(1986). 3/

3/ While the Associate Director's decision referenced 30 CFR 203.200(m) and (n), this was clearly a typographical error. The correct citation for the regulations quoted was 30 CFR 203.200(f) and (g)(1986).

Referring to the Agreement, the Associate Director emphasized that appellant and KCP&L not only specified a contract purchase price, but also provided for the contingency that nonconforming coal would be delivered to KCP&L. Thus, if KCP&L elected to accept a nonconforming shipment, the Agreement provided that the price would be not less than 90 percent of the standard purchase price for conforming coal. The Associate Director argued that, while the actual terms of the Agreement protected the interests of both the Government and Rochelle, Rochelle nevertheless proceeded to enter into "furious" negotiations with KCP&L, the need for which should have been obviated by the express contract terms. (Decision at 6.)

Noting that the applicable operational regulations required that the lessee place the coal production in a marketable condition prior to the determination of gross value for royalty purposes (see 43 CFR 3480.0-5(30) (1986), 43 CFR 3481.1(b) (1986) and 43 CFR 3485.2(h) (1986)), the Associate Director asserted that the coring procedures Rochelle used to test the coal together with the extraction techniques utilized to assure that the coal mined would meet the contract's specifications, in lieu of other reasonable measures which might have been taken, resulted in a failure "to place the production in a marketable condition in accordance with the January 1, 1985, agreement." (Decision at 8.) Further, she pointed out that Rochelle's "own records show that its election of rail cars that fit no industry standard for delivery of coal to KCP&L made it impossible for [Rochelle] to merchant the coal elsewhere for clearly it was the rail cars that were non-conforming--not the coal." Id.

In conclusion, the Associate Director held that Rochelle's acceptance of a renegotiated distressed coal price of $.01 per ton violated the terms of the Agreement for determining the price of nonconforming production, and that DACO properly disregarded the renegotiated price. However, the Associate Director also concluded that DACO's requirement that Rochelle pay royalty on the full contract price of $7.205 per ton ignored both the Agreement and events as they developed in this case. Accordingly, she modified DACO's order and directed Rochelle to pay royalties on the 11,182.875 tons of coal delivered to and accepted by KCP&L at the rate specified in Article III.C.2 of the Agreement for non-conforming coal, i.e., 90 percent of the $7.205 contract price. In all other respects, she denied Rochelle's appeal. It is from this decision that the present appeal arises.

In its statement of reasons in support of its appeal (SOR), Powder River, successor in interest to Rochelle, claims that the high sodium content in the December 16, 1986, shipment occurred in spite of Rochelle's good coal preparation practices. (SOR at 10.) Powder River asserts that it did not owe a duty to MMS to spend whatever money and incur whatever operational and marketing difficulties as were necessary to guarantee that no coal would leave the Rochelle Mine unless the coal complied with all applicable coal quality specifications. Powder River contends that if it owed MMS any duty with regard to preparing coal in a marketable condition, it was to use reasonably prudent coal preparation procedures that were consistent with accepted industry practices. (SOR at 11-12.)

Powder River also challenges the MMS assertion that the 1986 coal royalty valuation regulations required that the lessee place the production in marketable condition. (SOR at 12.) Powder River maintains that its decision to use mining extraction techniques to maintain quality control was reasonable and violated no duty to MMS. (SOR at 14.) Powder River asserts that it breached no duty to MMS by loading the December 16, 1986, shipment of coal into rail cars supplied by KCP&L, emphasizing that KCP&L supplied the rail cars and did so under Article VIII.B of the Agreement. (SOR at 14-15.) Finally, Powder River contends that the sale of the December 16, 1986, shipment of coal constituted an arm's-length sale and that Powder River properly valued that shipment of coal at $111.83 in accordance with 30 CFR 203.200 (l986). id.

In response, MMS asserts that it properly applied the applicable regulations in valuing Powder River's coal and argues that Powder River's sale of coal at $.01 per ton was not a bona fide transaction because it was based on a consideration other than the value of the coal, i.e., the money Powder River saved by not transferring the coal to other rail cars so it could be sold to another purchaser. Therefore, MMS argues, because it was not a bona fide transaction, MMS used the alternative valuation criteria set forth in 30 CFR 203.200 (g)(1)(i) and (vi) (1986) to determine the value of the coal, ultimately concluding that its proper value was the price provided under Article III.C of the Agreement which related to shipments of nonconforming coal, i.e., 90 percent of the otherwise applicable price. (Answer at 3-4.) Finally, MMS contends that, by selling the coal for $.01 per ton, Powder River breached its duty to market the coal for the benefit of both the lessee and lessor, concluding that Powder River's actions in this case constituted merely "selling" the coal rather than marketing it. Id. at 4-5, relying on California Co. v. Udall, 296 F.2d 384, 388 (D.C. Cir. 1961). For the reasons set forth below, we do not believe that either side is entirely correct in its analysis.

At the outset, it is useful to review the regulatory language applicable to this question. The Department's regulations for the time period at issue, found at 30 CFR 203.200 (1986), provided in pertinent part:

> (f) Where Federal royalty is calculated on a percentage basis, the value of coal for Federal royalty purposes shall be the gross value at the point of sale, normally the mine, except as provided at 30 CFR 203.200(h). For captive operations or other than arms-length transactions, the District Mining Supervisor shall determine gross value and the point of sale.
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> (g) The gross value shall be the unit sale or contract price times the number of units sold, unless MMS determines that:
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> (1) A contract of sale * * * is not a bona fide transaction between independent parties because it is based in whole or in part upon considerations other than the value of the coal * * * .

* * * [In that case] MMS shall determine the gross value of such coal taking into account:

(i) Any consideration received or paid by the operator/lessee in other related transactions.

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(vi) Such other relevant factors as the District Mining Supervisor may deem appropriate.

[1] The initial question, of course, is what is the contract of sale to which the regulation refers in 30 CFR 203.200(g)(1) (1986)? It is clearly not the Agreement entered into on January 1, 1985, between Rochelle and KCP&L. By its terms, that agreement became irrelevant once KCP&L exercised its contract right under Article III.C.1 to reject the shipment of nonconforming coal and to request a replacement shipment of coal which met the contract specifications. KCP&L's subsequent signing of the January 16, 1987, letter of agreement to purchase the coal at $.01 per ton is an action occurring outside of the contractual relationship manifested in the January 1, 1985, Agreement. Because of this, nothing in the Agreement necessarily controls the valuation of the coal involved in the December 16, 1986, shipment. Instead, the applicable contract for the purposes of determining value of that shipment under 30 CFR 203.200(g)(1) (1986) is the January 16, 1987, letter of agreement which valued the coal at $.01 per ton.

MMS has attempted to avoid utilization of this contract by arguing that this contract was based "on considerations other than the value of the coal" and asserting that Rochelle was willing to accept such a depressed price only because it desired to avoid either the expense of off-loading the coal onto standard railroad cars which might then be unloaded by other end-users on the one hand or, alternatively, the possibly massive liability to which it might be exposed if it agreed to indemnify KCP&L for any possible damage to the Hawthorn power plant caused by KCP&L's use of the nonconforming coal. In this assessment, we believe MMS is clearly correct.

There seems to be no question but that Rochelle sought to navigate between the Scylla of excess costs which would be generated if it reloaded its coal into rail cars which could be unloaded by other prospective purchasers and the Charybdis of being forced to assume liability for any damage to KCP&L's power plant caused by Rochelle's nonconforming coal by basically "giving" the coal away. Indeed, Rochelle does not really attempt to deny it. Rather, Rochelle argues that, given the circumstances in which it found itself, its actions were both prudent and reasonable. In making this argument, however, Rochelle attempts to glide over its own responsibilities for constructing the web in which it became enmeshed. In reality, it was Rochelle's shipment of nonconforming coal in nonstandard rail cars that directly led to the predicament in which Rochelle found itself.

Admittedly, the mere fact that nonconforming coal was shipped to KCP&L would not, by itself, support a finding that Rochelle, as lessee, failed to faithfully discharge its obligation to protect the interests of the United States, its lessor. Rochelle is perfectly correct when it argues that its obligations under the Federal coal lease are not fiduciary in nature but merely require the exercise of reasonable business judgment. See, e.g., Transco Exploration Co., 110 IBLA 282, 327, 96 I.D. 367, 391 (1989). Nothing in the record contradicts Rochelle's assertion that the failure of the coal shipment of December 16, 1986, to conform to the sodium specifications in its contract with KCP&L was aberrational and not based on any inherent deficiency in its mining, blending, or testing methods. 4/ Indeed, the terms of the Rochelle/KCP&L Agreement show that the parties clearly contemplated the possibility that a nonconforming shipment might occur since the parties deemed it prudent to expressly spell out the procedures which would be followed in such an eventuality. See Article III.C. Thus, contrary to MMS' assertions, we do not believe that the delivery of a nonconforming coal shipment, in and of itself, establishes any liability on Rochelle's part for increased royalty payments.

Rochelle's use of nonstandard rail cars to ship its coal is a different matter. As noted above, Rochelle had prudently provided in the contract that, should KCP&L decide to reject a nonconforming coal shipment, Rochelle was free to market it elsewhere. Prospective buyers of the nonconforming coal were, in fact, found. The problem was that none of these buyers had facilities which would allow them to unload the coal from the rail cars that Rochelle had used. Having clearly taken into account the possibility that nonconforming shipments might occur and having expressly provided for its right to market those shipments elsewhere, sound business judgment should have dictated that Rochelle would insure that its ability to remarket any nonconforming coal shipment was protected. This it failed to do when it allowed the coal to be shipped in nonconforming rail cars. 5/

4/ The MMS inference that Rochelle was obligated as lessee to institute procedures which would guarantee that nonconforming shipments never occurred, regardless of the costs of doing so, misses the point that Government mineral leases "are business arrangements entered into with an expectation of financial gain on both sides." Nola Grace Ptasynski, 63 IBLA 240, 248, 89 I.D. 208, 212 (1982). Indeed, the definition of "maximum economic recovery" found in the coal operational regulations expressly provides that it "means that, based on standard industry operating procedures, all profitable portions of a leased Federal coal deposit must be mined." 43 CFR 3840.0-5(a)(21) (emphasis supplied). Thus, it is insufficient for MMS to show that the avoidance of the type of problem which arose in the instant case might have been possible if some other mining or blending method had been used; rather, MMS was required to show that the method which appellant used was not based on "standard industry operating procedures" or was somehow otherwise violative of some express lease obligation or regulatory proscription. This it did not do.

5/ The fact that under the Agreement the rail cars were to be supplied by either KCP&L or the railroad (see Article VII.B) is an irrelevancy. Rochelle was obligated to use reasonable business judgment not merely in fulfilling the terms of its contract with KCP&L but in establishing the terms of that contract as well.

By doing so, Rochelle rendered its right to remarket the coal essentially illusory and laid the groundwork for the circumstances in which it eventually found itself. Rochelle failed to exercise reasonable business judgment and this failure resulted in a virtual "fire sale" of the coal. MMS is completely correct in refusing to allow Rochelle to pay royalties based on the $.01 per ton payments it eventually accepted.

[2] The question then becomes what is the proper valuation for royalty purposes of the coal which was sold? The Associate Director concluded that this value could be derived from the terms of the January 1, 1985, Agreement, pointing out that, under Article III.C.2, while KCP&L had the right to accept a nonconforming shipment at a reduced price to compensate for the loss of efficiency, the Agreement expressly provided that "in no event shall such price be less than 90 percent of the price then in effect under this Agreement." The problem with the MMS analysis is that KCP&L did not exercise its option under Article III.C.2 to accept nonconforming coal at a reduced price but rather exercised its rights under Article III.C.1 to reject the nonconforming shipment. It is undisputed by MMS that Rochelle then attempted to sell this shipment to other parties. As noted above, these attempts to do so failed not because the coal, itself, was unmarketable but rather because the nonconforming nature of the rail cars used to ship the coal made its unloading impossible for these prospective buyers. Only then did Rochelle and KCP&L sign the letter agreement which both valued the coal at $.01 per ton and limited Rochelle's liability for damage to the Hawthorn plant. While KCP&L ultimately "accepted" the shipment, it did not do so within the confines of the January 1, 1985, Agreement and the valuation terms of that Agreement cannot be said to necessarily control the value assigned to the coal shipped by Rochelle.

On the other hand, MMS did note that Rochelle had sold similarly "distressed" shipments to other purchasers at a price of $3.75 per ton. See Field Report dated January 20, 1993, at 5. Rochelle was presumably unable to sell the coal involved herein at this price because of the rails cars which it had utilized in shipping the coal. The costs of reshipping the coal in cars which could be unloaded by such prospective purchasers, while perhaps relevant to Rochelle's own calculations of profit and loss, are irrelevant to the valuation of the coal for royalty purposes, since, as explained above, those costs arose solely because of Rochelle's failure to exercise reasonable business judgment.

The value which Rochelle generally received for "distressed coal" is, we believe, the best evidence in the record of the true market value of the nonconforming coal shipment and is properly utilized as such under the provisions of 30 CFR 203.200(g)(1)(i). MMS' royalty is properly assessed against this valuation of the tonnage sold rather than $.01 per ton that Rochelle ultimately accepted. The Associate Director's decision is hereby modified to reflect this value for the coal sold to KCP&L under the letter agreement of January 16, 1987.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed as modified for the reasons stated herein.

James L. Burski
Administrative Judge

I concur:

Gail M. Frazier
Administrative Judge